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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1082

UNITED STATES OF AMERICA, PETITIONER

v.

MISSISSIPPI CHEMICAL CORPORATION, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (R. 342–346)[1] is not reported. The majority and dissenting opinions of the court of appeals (R. 347–373) are reported at 431 F. 2d 1320.

JURISDICTION

The judgment of the court of appeals (R. 374) was entered on September 14, 1970. The petition for a writ of certiorari was filed on December 10, 1970, and certiorari was granted on February 22, 1971 (R. 375). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

[1] "R." references are to the separately bound record appendix.

QUESTION PRESENTED

Whether the amounts paid by the respondent cooperatives for purchases of the Class C stock of the New Orleans Bank for Cooperatives, made in connection with loans secured from that Bank, are nondeductible capital outlays rather than deductible interest or ordinary and necessary business expenses.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 and of the Treasury Regulations on Income Tax (1954 Code) are set forth in Appendix A, *infra,* pp. 45–46. The pertinent provisions of the Farm Credit Acts, and amendments thereto, are set forth in Appendix B, *infra,* pp. 47–67.

STATEMENT

Respondents, cooperative associations,[2] are members of, and borrowers from, the New Orleans Bank for Cooperatives (R. 93, 111). They filed federal income tax returns for the years in suit[3] on the basis of a fiscal year ending June 30, using the accrual method of accounting (R. 93, 112, 349–350).

The New Orleans Bank for Cooperatives is one of twelve regional banks for cooperatives which, together with the Central Bank for Cooperatives in Washington, D.C., were originally chartered in 1933.[4] These

[2] As defined in Section 15(a) of the Agricultural Marketing Act, c. 24, 46 Stat. 11, Appendix B, *infra,* p. 47.

[3] In the case of Mississippi Chemical Corporation, the fiscal years 1961 through 1963; in the case of Coastal Chemical Corporation, the fiscal years 1958 through 1963.

[4] Section 2, Farm Credit Act of 1933, c. 98, 48 Stat. 257, Appendix B, *infra,* p. 48. Unless otherwise specified, references to farm cooperative legislation are to this Act, as amended.

banks are themselves cooperatives and are structured in accordance with the provisions of the Farm Credit Act of 1955, c. 785, 69 Stat. 655. Their purpose is to furnish farmer cooperatives a specialized and readily available source of financial services, including credit, at the lowest cost consistent with sound business practices (Ex. 18–B, pp. 1–2). They are capitalized under a mechanism adopted by statute whereby the initial capital is contributed by the government but is thereafter gradually replaced by capital belonging to the member borrowers. S. Rep. No. 1201, 84th Cong., 1st Sess., p. 1. The goal of this statutory mechanism is the establishment of permanent cooperative banks, with increasing borrower participation in management and control, and, ultimately, complete borrower ownership, of the banks. Sec. 2, Farm Credit Act of 1953, Appendix B, *infra*, pp. 62–63; S. Rep. No. 1201, *supra*, pp. 5–6.

The banks are authorized to issue three classes of stock—Class A, Class B and Class C—each with a par value of $100 per share. Section 42(a), Farm Credit Act of 1933, Appendix B, *infra*, pp. 53–57. Class A stock represents the government's original capital contribution to each bank. Under the Act, it is nonvoting, pays no dividends and is to be retired at par according to a method which depends upon the amount of Class C stock purchased by cooperatives such as the respondents, and upon the bank's net savings. Section 42(a)(1). Class B stock is intended for sale to investors in the public at large as well as to farmer cooperatives. S. Rep. No. 1201, *supra*, p. 10. It is issued at par, is nonvoting and

may pay noncumulative dividends not to exceed four percent per year. After all Class A stock has been retired, Class B stock may be retired at par, the oldest Class B stock to be retired first. Section 42(a)(2). Class C stock is the voting, common stock of the banks. S. Rep. No. 1201, *supra*, p. 10. Issued at par ($100), it may normally be purchased only by farmer cooperatives. Section 42(a)(3).

There are four ways in which farmer cooperatives may acquire Class C stock.

First, each must purchase at least one share of Class C stock in order to be a member and to be eligible to borrow. Section 42(a)(3).

Second, each borrower must invest quarterly in Class C stock an amount equal to not less than 10 nor more than 25 percent of the amount of interest which it pays to the bank on its loans during the calendar quarter. Section 42(a)(3). The rate for the New Orleans Bank during the years in issue was 15 percent (R. 94, 112).

Third, as of the end of the fiscal year each borrower receives additional Class C stock as "patronage refunds" or "patronage dividends." Such stock is payable out of each bank's net savings, after deduction of operating and certain other expenses, in the proportion that the amount of interest earned on the loans of each borrower bears to the total interest earned on the loans of all borrowers during the fiscal year. Section 42(a)(3).

Fourth, in addition to receiving Class C stock as patronage dividends, borrowers receive as of the end of each fiscal year an "allocated surplus" credit which

also is payable out of each bank's net savings. Like patronage dividends, a bank's allocated surplus is credited to each member in accordance with the proportion that the interest earned on its loans bears to the interest earned on the loans of all members during the fiscal year. Farm Credit Administration Regulations, Section 70.162,[5] Appendix B, *infra,* pp. 65–66. When the surplus account reaches 25 percent of the total outstanding capital stock of the bank, the excess may be distributed to members in the form of Class C stock, with members with the oldest allocated surplus credits receiving the first stock. (Stip. Ex. 17, pp. 48–49.)

Only the tax treatment of the additional Class C stock acquired in connection with loans—that is, the stock referred to in paragraph "Second," above—is here in dispute.

A shareholder of Class C stock is entitled to one vote, regardless of the number of shares it owns. The shareholder may vote for nominees to the Federal Farm Credit Board[6] and, during the years in issue, for one of the directors of the local bank. Section 5 (d), (e) and (f), Farm Credit Act of 1937, Appendix B, *infra,* pp. 59–62; Section 4(a), Farm Credit Act of 1953, Appendix B, *infra,* pp. 63–64. If a shareholder's account with the bank is dormant for a period

[5] References herein are to the Farm Credit Administration Regulations as they appeared in the January 1, 1966 edition of 6 C.F.R. These regulations are now codified in 12 C.F.R., Parts 670–673.

[6] The Federal Farm Credit Board acts through the Farm Credit Administration, which in turn supervises the Banks for Cooperatives (R. 168, 181).

of two years, the shareholder's voting privileges are suspended. Section 42(a)(3).

Class C stock is redeemable at full par value, but not until the stock prior to it—all Class A stock, earlier issued Class B stock, Class B stock issued during the same fiscal year, and earlier issued Class C stock—has been redeemed.[7] Section 42(a)(3). But where the borrower-Class C stockholder is in bankruptcy or receivership, has ceased operations or is unable to pay its debts to the bank, its Class C stock, upon which the bank has a lien, may be redeemed immediately at full par value (R. 45–46; Stip. Ex. 17, p. 44). See Sections 36(d), 42(c). While Class C stock is not freely transferable, it may be transferred to other cooperatives with the consent of the bank (Ex. 17, pp. A69–A70). Such approved transfers have occurred incident to liquidations, mergers or accommodations between cooperatives (R. 107, 275–291).

Although a form for Class C stock certificates has been approved by the Farm Credit Administration, the Board of Directors of the New Orleans Bank exercised the discretion given it in the bylaws not to issue certificates. Instead, the bank reflects in its stock ledger the number of shares of Class C stock owned by each cooperative association and the manner in

[7] The Farm Credit Administration advises that, for purposes of retirement, Class C stock acquired through conversion of allocated surplus is deemed to have been issued at the time the surplus allocation was made.

which such stock was acquired—whether by purchase, by patronage dividends, or through allocated surplus conversions. Shortly after the end of each fiscal year, the bank notifies each owner of the number of shares owned at the beginning and end of that year. (R. 96, 114–115; Stip. Ex. 17, p. 45.)

Since the enactment of the Farm Credit Act of 1955, substantially all the capital represented by the Class C stock has been applied by the banks to revolving out and retiring the Class A stock. See Section 42(a)(1). The Farm Credit Administration advises that the retirement of all the Class A stock in all the banks was completed as of December 31, 1968, the date on which the New Orleans Bank retired its last Class A stock. The banks have since redeemed the earliest purchased Class C stock. According to Farm Credit Administration records, the first series of Class C stock of the New Orleans Bank, issued as of the close of the fiscal year ended June 30, 1956, was retired 14 years later, shortly after the close of the fiscal year ended June 30, 1970.

Respondents each owned one eligibility share of Class C stock in the New Orleans Bank, the cost of which they capitalized as an investment (R. 97, 116). During the taxable years here in issue, they purchased Class C stock in connection with their loans from the New Orleans Bank, and received patronage dividends and allocated surplus credits in the amounts shown in

the margin.* On their federal income tax returns for these years, respondents deducted the stated interest payable on the loans. They also deducted as interest $99 out of each $100 paid for Class C stock, treating the $1 balance as the cost of acquiring an asset. The Commissioner allowed the deductions for the stated interest, but disallowed the deductions representing the cost of the Class C stock on the ground that purchases of such stock constituted nondeductible capital investments. Respondents paid the resulting deficiencies and in due course brought these consolidated actions for refund. (R. 5–15, 55–70.)

At trial in the district court, respondents' witnesses testified (R. 245–247, 265–266) that the Class C stock in question was in essence valueless, because it could be neither sold nor transferred except in unusual circumstances, and because it gave the owner only the right to recover the par value of the shares at some indefinite future time. Since the present value of such a right was nominal, and since the stock was purchased as a condition to continued borrowing from the bank, the court concluded that its cost was, in substance, merely additional interest within the mean-

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Year	Class C stock purchased	Patronage dividends	Allocated surplus
Mississippi Chemical Corporation (R. 117–118; Stip. Ex. 31):			
1961	$18,940.09	$27,489.40	$12,202.89
1962	16,865.75	25,152.83	11,238.75
1963	19,307.35	28,888.10	12,329.84
Coastal Chemical Corporation (R. 98–99, 123–124):			
1958	$11,788.19	$14,345.04	$6,781.42
1959	33,956.20	47,361.32	20,947.65
1960	47,119.23	51,689.59	22,845.55
1961	41,712.88	60,541.52	26,875.13
1962	35,072.16	52,305.05	23,370.87
1963	42,151.02	63,067.29	26,918.00

ing of Section 163(a) of the Internal Revenue Code (Appendix A, *infra*, p. 45). (R. 342–346.) On appeal a divided Fifth Circuit affirmed (R. 347–373).[9] Neither the district court nor the court of appeals decided whether, as respondents alternatively claimed, the cost of the Class C stock was deductible as an ordinary and necessary business expense under Section 162(a) (Appendix A, *infra*, p. 45).[10]

SUMMARY OF ARGUMENT

A

The Internal Revenue Code allows a current deduction for interest expense and for ordinary and necessary business expenses. On the other hand, the cost of acquiring an asset—an item of value—having a useful life extending substantially beyond the close of the taxable year is not currently deductible. The question here is whether respondents' required outlays for Class C stock constituted interest or business expenses, or whether the Class C stock is an item of continuing value in respondents' hands, so that its cost must be capitalized.

[9] Respondents reported $1 per share of the patronage refunds they received as a reduction of interest expense, but did not include in income the remaining $99 of par value of each share. In the district court, the government contended that the entire par value of each patronage refund share constituted income upon receipt. The district court decided this issue adversely to the government, and the government did not appeal.

[10] The district court did not mention the ordinary and necessary expense question. The court of appeals referred to Section 162(a) (R. 357–358), but found that treatment of the cost as interest was "more logical" (R. 358) and did not definitively resolve the issue.

B

The Farm Credit Act of 1955 and the legislative history of that Act, as well as earlier farm cooperative legislation, argue strongly in favor of the latter conclusion. The architects of the Banks for Cooperatives system, both in and out of Congress, intended member stock purchases to be the mechanism by which farmer cooperatives would obtain actual ownership and increasing control of the banks. Such ownership and control have been considered a prime necessity by these leaders in their effort to furnish farmers the opportunity to achieve their economic goals. This concept is the very antithesis of respondents' claim that such purchases are merely another short-term expense of doing business from which they derive no benefits extending beyond the taxable year of purchase.

Moreover, the terminology Congress used in the 1955 Act and in the legislative history also shows that the payments in question are not to be considered interest or another type of expense. Congress provided for the issuance of "stock" and referred to the payments as "capital contributions" and "investments." Each of these terms describes an item generally recognized as having continuing value. While the terminology used in a non-tax statute does not necessarily control tax consequences, we submit that the clear congressional intention reflected by that terminology should be given effect in determining the tax treatment of required Class C stock purchases.

C

Despite the language of the 1955 Act and the legislative history, the majority below concluded that respondents did not acquire an item of continuing value when they made required Class C stock purchases, but merely paid additional interest over and above the nominal value of the stock, $1 per share. Emphasizing that the substance rather than the form of the stock payments must control, the court held that purchased Class C stock bore no return and, since it could not easily be transferred, entitled the owner only to recover its original payment at an indefinite future time.

Neither the fact that respondents were required to invest in Class C stock in connection with their loans, nor the limitations on transferability of the stock, could convert its cost into a deductible expense if it otherwise would qualify as an income-producing asset providing benefits in future years. Our position is that under the court's own substance-over-form analysis, the purchased Class C stock must be considered such an asset.

By making the required stock purchases, in addition to paying interest on its loans, respondents became entitled to receive in the future not only a return of the purchase price, but also a portion of the bank's profits for the year in which the stock was purchased. Originally distributed in the form of patronage dividends and allocated surplus credits, this return is ultimately paid in cash. In concluding that respondents earned no return on their investment, the court of appeals erroneously looked at the purchased Class

C stock in isolation, instead of considering the reality of the total amount that respondents will receive when a year's purchased stock, the patronage dividend stock of the same year, and the related allocated surplus credit stock is redeemed.

In addition to the return earned by Class C stock, the stock provides its owners with intangible benefits extending substantially beyond the close of the taxable year in which the stock is purchased. These benefits include the opportunity to obtain loans at favorable rates, a voice in the management of the bank and various financial services, all of which led the dissenting judge below to conclude that the Class C stock purchased had intrinsic value.

The fact that the payments for Class C stock can be viewed as payments for services does not make the stock any less an item of continuing value than the stock of an ordinary corporation. Nor does the different way in which a cooperative divides its profits mean that cooperative stock is not such an item. Contributions to the capital of an ordinary corporation have consistently been held nondeductible. Contributions to the capital of a cooperative corporation also should be nondeductible.

D

Although the court of appeals recognized that the Class C stock had the nominal value of $1 per share assigned to it by respondents, it held that the remaining $99 of par value per share was deductible. There is no basis in the Code for allowing a loss on the purchase of an asset—even one of nominal value—

unless that loss is realized by a sale or other final transaction. While respondents seek to avoid this rule by claiming interest and business expense deductions, it is settled that in the absence of realization of a loss, the cost of an asset may be recovered only through depreciation or amortization.

E

Not in point here are opinions in usury cases to the effect that a lender's requirement that a borrower purchase property from him at an excessive price, as a condition to making the loan, gives rise to interest to the extent that the price of the property exceeds its fair market value. These cases are inapposite because the price of Class C stock is not excessive; the stock earns a return and also has intrinsic value. Apart from this, the principle of these cases is not unqualified. This Court and the great majority of the state and lower federal courts have held that the stock purchases which building and loan associations (a type of cooperative) have required borrowers to make as a condition to obtaining loans, under a system similar to that used in the instant case, do not constitute additional interest for purposes of the usury laws. The principal caveat attached to such building and loan arrangements, obviously not present here in view of the congressional structuring of the system, is that the stock purchases must not constitute a corrupt agreement to mask usury.

ARGUMENT

CLASS C STOCK PURCHASED BY RESPONDENTS CONSTITUTES AN ASSET WITH A USEFUL LIFE EXTENDING SUBSTANTIALLY BEYOND THE CLOSE OF THE TAXABLE YEAR

A. INTRODUCTION

Section 163(a) of the Internal Revenue Code allows a deduction for "all interest paid or accrued within the taxable year on indebtedness." In *Deputy* v. *du-Pont,* 308 U.S. 488, 498, this Court construed the term "interest on indebtedness" to mean "compensation for the use or forbearance of money."

Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *." An expense is "necessary" if it is "appropriate and helpful" in the taxpayer's business. *Welch* v. *Helvering,* 290 U.S. 111, 113; *Commissioner* v. *Tellier,* 383 U.S. 687, 689. But this Court held long ago that to be deductible under Section 162(a), an expense must be "ordinary" as well. See *Welch* v. *Helvering, supra* at 113–116. More recently, in the *Tellier* case, the Court explained (383 U.S. at 689–690) that "[t]he principal function of the term 'ordinary' in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset."

Although interest, and ordinary and necessary business expenses, are currently deductible, "any expenditure which results in the creation of an asset having a

useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred." Treasury Regulations on Income Tax (1954 Code), Section 1.461–1(a) (2) (Appendix A, *infra*, pp. 45–46).[11] See *Wells-Lee* v. *Commissioner*, 360 F. 2d 665 (C.A. 8); *Teitelbaum* v. *Commissioner*, 294 F. 2d 541 (C.A. 7), certiorari denied, 368 U.S. 987; *Darlington-Hartsville Coca-Cola B. Co.* v. *United States*, 273 F. Supp. 229, 231 (D. S.C.), affirmed, 393 F. 2d 494, 496 (C.A. 4), certiorari denied, 393 U.S. 962. Such an expenditure must be capitalized and recovered through depreciation or amortization, or when gain or loss is realized upon the sale or other disposition of the asset. See *Woodward* v. *Commissioner*, 397 U.S. 572, 574–575.

While the Code nowhere defines the term "asset" as used in the quoted regulations,[12] the dictionary defines it as "an item of value owned" (Webster's Third New International Dictionary (Unabridged), p. 131), and we do not believe that respondents would dispute that this definition is applicable for present purposes. Since it is clear that respondents owned the Class C stock in question, the issue narrows to whether that stock constitutes an item of continuing value, or whether the benefit from the expenditure made is exhausted in the year of payment, so that the expenditure is simply a current cost of doing business.

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[11] The cited regulation prescribes this rule for accrual basis taxpayers like respondents. The same rule applies to cash basis taxpayers. Treasury Regulations on Income Tax (1954 Code), Section 1.461–1(a)(1).

[12] Section 1221 defines "capital asset."

This issue has engendered a variety of differing views in the lower courts. In *Penn Yan Agway Cooperative, Inc.* v. *United States,* 417 F. 2d 1372, the Court of Claims, using an analysis similar to that employed by the court below, held that the purchase price of Class C stock in excess of $6.90 a share constituted deductible interest. In *M.F.A. Central Cooperative* v. *Bookwalter,* 286 F. Supp. 956 (E.D. Mo.), the district court rejected the interest argument, but held that the entire cost of the stock was deductible as an ordinary and necessary business expense. On appeal, the Eighth Circuit agreed with the conclusion on interest, but reversed on the business expense issue, holding that the cost of the stock was nondeductible in its entirety. 427 F. 2d 1341, petition for a writ of certiorari pending, No. 824, this Term. The Tax Court reached the same conclusion in *Hunter* v. *Commissioner,* 46 T.C. 477.

B. THE STATUTES GOVERNING THE BANKS FOR COOPERATIVES, TOGETHER WITH THEIR LEGISLATIVE BACKGROUND, SHOW THAT CONGRESS CONSIDERED CLASS C STOCK TO BE AN ITEM OF CAPITAL OWNERSHIP OF CONTINUING VALUE

The system of the Banks for Cooperatives is an outgrowth of the Federal Land Bank System created by the Federal Farm Loan Act of 1916, c. 245, 39 Stat. 360. Federal Land Banks were established in recognition of the farmer's need for capital, his frequent inability to obtain it, and the high rates of interest he was charged. S. Rep. No. 144, 64th Cong., 1st Sess. pp. 1–3; see Stip. Ex. 18A, p. 1. Originally capitalized by the government, the Federal Land Banks were required by the governing statute to revolve out the

government's capital and to replace it with capital furnished by members. This was to be accomplished by requiring a member to purchase stock in a Land Bank Association equal to five percent of the amount of its loan.[13] Federal Farm Loan Act, *supra,* Section 5, 7, 8; S. Rep. No. 144, *supra,* p. 4; R. 164. The government's capital was completely revolved out by the end of 1947. S. Doc. No. 7, 84th Cong., 1st Sess., p. 4; S. Rep. No. 1201, *supra,* p. 20.

The Farm Credit Act of 1933, c. 98, 48 Stat. 257, supplemented the 1916 Act with a parallel system to supply credit to cooperatives engaged in agricultural production and marketing. S. Rep. No. 124, 73d Cong., 1st Sess., p. 1; H. Rep. No. 171, 73d Cong., 1st Sess., p. 1. Again, the system was grounded in cooperative principles, with an initial supply of government capital to be replaced gradually by the capital of the borrowers themselves. S. Rep. No. 124, *supra*; R. 164. The government's original subscription amounted to $110 million. S. Doc. No. 7, *supra,* p. 6; S. Rep. No. 1201, *supra,* p. 5. In accordance with the announced goal of cooperative ownership of the banks, Section 43 of the 1933 Act provided that, if a bank's resources permitted, the government's stock should be redeemed. As was the case under the Federal Farm Loan Act, *supra,* Section 35 of the 1933 Act required each cooperative association

[13] Under the 1916 Act, farmers did not borrow directly from the Federal Land Banks but from national associations which acted as middlemen for securing loans from the banks. Both the banks and the associations operated under cooperative principles. Federal Farm Loan Act, *supra*, Section 7; S. Rep. No. 144, *supra*, pp. 4–5.

which borrowed from the banks to invest an amount equal to five percent of the loan in stock of the banks.

As business of the banks increased, it was found advisable to increase the amount of stock subscribed by the government to a peak of $178.5 million in 1945. S. Doc. No. 7, *supra*; S. Rep. No. 1201, *supra*. The banks thereafter were subjected to criticism because of the slow rate at which government capital was being replaced. By September, 1954, the government's share of the Cooperative Banks' capital still exceeded $150 million, while the share held by farmers' cooperative associations stood at less than $19 million; the banks' earned surplus amounted to approximately $80 million. S. Doc. No. 7, *supra*. The relatively small capital share of the banks owned by cooperatives was traceable to a provision in Section 35 of the 1933 Farm Credit Act allowing borrower cooperatives, upon payment of their loans, to have their stockholdings retired and cancelled by the Banks (R. 165).

In an effort to accelerate borrower ownership, the Federal Farm Credit Board recommended that new "legislation be enacted which would convert the banks for cooperatives from institutions in which the United States Government holds substantial investments of capital stock into institutions which would become wholly capitalized by their users." S. Doc. No. 7, *supra*, p. 6. Congress thereupon enacted the Farm Credit Act of 1955, c. 785, 69 Stat. 655.

The statute provided for an orderly, mandatory replacement of government-held stock with stock owned by cooperative associations. S. Rep. No. 1201, *supra*, p. 1; S. Doc. No. 7, *supra*, p. 6. Government capital would

be repaid by substituting in its place capital of the members and users of the banks. Senate Hearings Before a Subcommittee of the Committee on Agriculture and Forestry on Farm Credit Act of 1955, 84th Cong., 1st Sess., pp. 51, 110, 111; S. Rep. No. 1201, *supra*. "Borrowing cooperatives would continually make capital contributions to the system so long as they used its credit service. Each year final net savings (after taxes, dividends, reserves, and surplus requirements) would be distributed as patronage refunds to borrowing cooperatives in the form of capital stock, all of which capital would remain in the system until all of the capital stock of the United States had been retired." S. Rep. No. 1201, *supra*, p. 6. After the government's capital had been retired, "capital investments of borrowers would be revolved in accordance with the cooperative principle of retiring first the oldest outstanding stock." S. Doc. No. 7, *supra*, p. 6; see House Hearings Before the Subcommittee on Agriculture on Farm Credit Act of 1955, 84th Cong., 1st Sess., pp 30–31.

The dual purposes of the 1955 Act thus were to raise private capital to replace the government's capital in the banks,[14] and to accelerate farmer ownership and control of the entire agricultural credit system, of which the Banks for Cooperatives are a significant part. See

[14] The banks have always treated Class C stock as part of their capital. It appears in the usual place for shareholders' capital contributions and is listed under the title "Stockholders' Equity" on their balance sheets (R. 148). It is available to satisfy creditors' claims only after all of the banks' other funds (current earnings, loss reserves and allocated surplus) have been exhausted (R. 257).

R. 164–177; Stip. Ex. 18A, pp. 17–23, 25, 32–33, 36–37. The latter purpose was explained at the Senate Hearings on the proposed legislation which became the Farm Credit Act of 1955 as follows (Senate Hearings, *supra*, p. 60):

> The purpose * * * is to make these institutions fully cooperative and to place full ownership and responsibility for their operations and success in the hands of those eligible to borrow from them. * * *[The] idea is that it is better for farmers to solve the economic problems of American agriculture to the greatest possible extent by means of voluntary cooperative self-help and to reduce correspondingly the need for government programs.

To allow borrowers to treat the costs of Class C stock as interest or another type of current expense would be inconsistent with both these purposes.[15]

It seems undeniable, in view of the legislative history of the 1955 Act and the background of the Banks for Cooperatives system, that Congress considered Class C stock to be an investment of capital, an asset with a useful life extending substantially beyond the close of the taxable year, rather than simply an increase in the rate of interest charged on loans to cooperatives, or another type of current expense. If Congress had thought that the banks' income was inadequate, it would have been a simple enough matter

[15] It would also be inconsistent with the banks' own treatment of the Class C stock which they, as members of, and borrowers from, the Central Bank for Cooperatives are required to purchase as a condition of obtaining their loans. See Section 42(a)(3); Stip. Ex. 17, p. 40. The New Orleans Bank has always accounted for such Central Bank Class C stock as an asset on its books (R. 148).

for it to have authorized an increase in the rate of interest charged, or to have imposed another charge on borrowers, when it enacted the 1955 Act. But that is not what Congress did. It chose instead to denominate the additional payments made by borrowers as being for the acquisition of "stock," and referred to the payments as "capital contributions" or "investments." All of these terms connote items commonly considered to be assets having continuing value.

We recognize, of course, that Congress did not prescribe the tax treatment of Class C stock when it enacted the 1955 Act, and that the terminology used in a non-tax statute is not conclusive for tax purposes. But the tax provisions here involved are not divorced from financial reality, but rather generally follow well understood concepts of interest, current expense and capital investment. Furthermore, it is necessary here to determine the tax consequences of what the majority below described as "ambiguous transactions" (R. 356). Under these circumstances, it is entirely fitting to resolve the ambiguities in a manner consistent with Congress' unmistakable intention, even though that intention was expressed in a non-tax context.[16]

[16] Although the Banks for Cooperatives were exempt from income tax during the years here in issue, each became subject to tax when it retired all of its Class A stock. Sec. 63, Appendix B, *infra*, pp. 58–59. In consequence, if the stock purchase payments are held to be deductible, and if, as a corollary, the banks are required to report the payments as income, tax will be due on the payments. We are advised by the Farm Credit Administration, based on their study covering the last five years, that the banks will suffer a loss in lending power of approximately $100 million over a five-year period if tax is imposed on the payments for Class C stock.

C. THE CLASS C STOCK PURCHASED BY RESPONDENTS HAS CONTINUING VALUE

In holding that the costs in question were deductible, the court below cited a variety of factors which, in its view, required the conclusion that the Class C stock had no practical value in respondents' hands. The most important among these were that the purchases had to be made to obtain and continue loans; that the stock was subject to severe restrictions on transferability and convertibility;[17] and that the stock paid no dividend and had no growth potential.

Neither of the first two factors, whether operating independently or together, can convert a cost that otherwise would be nondeductible into a currently deductible expense. Compare *Commissioner* v. *Lincoln Savings and Loan Association*, No. 544, this Term, certiorari granted, 400 U.S. 901, on which oral argument was heard on February 23, 1971. Thus, it has been held in a variety of situations that the cost of an item in the nature of an asset having a useful life extending substantially beyond the close of the taxable year may not be deducted, even if the cost is forced upon the taxpayer by law or by economic cir-

[17] The restrictions are not as severe as the court of appeals thought (R. 351). The record shows five transfers of Class C stock from one cooperative to another (R. 107, 275–291), one of which involved a payment of $12,000 for Class C stock and related allocated surplus credits (R. 280–282). The bank also redeemed Class C stock for full book value on 10 occasions during the years in issue (R. 130, 133, 241; see R. 45–46, 238–239, 248–249; Farm Credit Adm. Regs., Secs. 70.165, 70.165a, Appendix B, *infra*, pp. 66–67). Cf. *Columbia Bank for Cooperatives* v. *Lee*, 368 F. 2d 934, 936–940 (C.A. 4).

cumstances.[18] And, it is likewise clear that such a cost does not become deductible merely because the asset may not easily be converted into cash or other liquid assets through sale or other disposition.[19] While restrictions on transferability may make a long-lived asset less desirable than it otherwise would be, they do not change its fundamental character.

As for the conclusion below that purchased Class C stock produces no income, our position is that the court was in error, and that such stock in substance provides purchasers with long-term benefits in the form of a return on their investment. Moreover, the stock also has intrinsic value, in that it provides purchasers with a variety of intangible long-term benefits. We turn now to a detailed consideration of the continuing value of Class C stock.

1. The stock in substance earns a return

The court below thought (R. 356) that "incisive realism" justified current deductibility of purchased Class C stock because such stock gave its owners only

[18] See, *e.g.*, *Welch* v. *Helvering*, 290 U.S. 111; *Woodward* v. *Commissioner*, 397 U.S. 572, 579 n. 8; *Woolrich Woolen Mills* v. *United States*, 289 F. 2d 444, 448 (C.A. 3); *Falstaff Beer, Inc.* v. *Commissioner*, 322 F. 2d 744, 745 (C.A. 5); *Teitelbaum* v. *Commissioner*, 294 F. 2d 541, 544 (C.A. 7), certiorari denied, 368 U.S. 987, and cases cited therein; *Russell Box Co.* v. *Commissioner*, 208 F. 2d 452, 454, 455 (C.A. 1); *RKO Theatres, Inc.* v. *United States*, 163 F. Supp. 598 (Ct. Cl.).

[19] See, *e.g.*, *Connecticut Light and Power Co.* v. *United States*, 368 F. 2d 233, 241–242 (Ct. Cl.); *Robertson* v. *Steele's Mills*, 172 F. 2d 817 (C.A. 4); *Gauley Mt. Coal Co.* v. *Commissioner*, 23 F. 2d 574, 578 (C.A. 4); *J.C. Cornillie Co.* v. *United States*, 298 F. Supp. 887, 896–897 (E.D. Mich.); *Lutz* v. *Commissioner*, 2 B.T.A. 484.

the right to receive their money back, with no return, at some indefinite future time. It quoted with approval (R. 354) the Court of Claims' remark in *Penn Yan Agway, supra,* 417 F. 2d at 1378, that substance must prevail over form "in the extremely practical field of taxation * * * ." But, in our view, the court failed to apply this standard properly in reaching the conclusion that Class C stock earns no return.

When a borrower cooperative purchases Class C stock, thus fulfilling its obligation under its loan agreement (R. 127), it becomes entitled to share in the distribution of the bank's net savings at the end of the fiscal year. Shortly thereafter, the bank sends each borrower a statement (R. 117, 130) showing not only the Class C stock which it purchased during the year, but also the Class C stock received as a patronage dividend. Surplus allocations are also credited to borrowers at this time (R. 99, 118, 123–124; Stip. Ex. 31).

These distributions of patronage dividends and allocated surplus are not insubstantial. For example, for its fiscal year ended June 30, 1961, Mississippi Chemical Corporation received $27,489.40 in patronage dividends, and $12,202.89 in allocated surplus credits (see n. 8, *supra*), while it made stock purchases in that year of $18,940.09 (*ibid.*). Assuming that the 14-year retirement period for Class C stock continues (see p. 7, *supra*), and leaving aside completely its share of allocated surplus for the year, Mississippi Chemical will receive in cash shortly after the close of fiscal 1975, not only its original investment of $18,940.09, but an additional $27,489.40. This represents

an average annual return on its investment of 6.16 percent. If the redemption period were 10 years, the average annual return would be 9.38 percent; if it were as long as 30 years, the return would be 3.03 percent.[20]

It is no answer to the foregoing analysis to say that the return was not earned on the investment, but was simply a refund of excessive interest charges. In the first place, the patronage dividend is paid out of the bank's entire earnings, not merely the interest it earns on cooperative loans. Second, it is not by the act alone of borrowing that a cooperative qualifies to receive patronage dividends; it must also purchase Class C stock. Indeed, we are advised by the Farm Credit Administration that a non-cooperative borrower which is not required to purchase stock receives no patronage dividend.[21] Third, and most

[20] As we have noted (see n. 16, *supra*), the Banks for Cooperatives became subject to tax when they retired all of their Class A stock (December 31, 1968, in the case of the New Orleans Bank). Sec. 63, *supra*. Under the applicable provisions of the Internal Revenue Code (Sections 1382(b)(1) and 1388(c)(1)), a bank must pay 20 percent of its patronage dividends in cash to prevent taxation to it of the full amount of the patronage dividends distributable. According to information supplied by the Farm Credit Administration, the New Orleans Bank has made the required cash distributions beginning in 1969. This means that respondents now realize an even higher rate of return on their Class C stock payments.

[21] Although, under the 1955 Act, the Banks for Cooperatives are empowered to require non-cooperative borrowers to purchase Class C stock (see H. Rep. No. 863, 84th Cong., 1st Sess., p. 10), the Farm Credit Administration advises that they have not exercised this authority. A non-cooperative may become indebted to a Bank for Cooperatives if, for example, it purchases property subject to a loan made by the bank.

important, we are dealing here with matters of substance and form. Although the governing statute provides that patronage dividends and allocated surplus are to be distributed to farmer cooperatives in accordance with the ratio of the interest paid by each cooperative to the interest paid by all, the result would be the same if the statute had provided that the dividends and allocated surplus would be distributed in accordance with the proportion of each cooperative's required Class C stock purchases to total Class C stock purchases. This is so because such purchases themselves are made in accordance with the ratio of the interest paid by each cooperative to the interest paid by all.

If the statute had provided for distributions in accordance with the ratio of required Class C stock purchases, it would be clear that the Class C stock was an income-producing asset which, if held to maturity, would produce significant benefits over and above a mere return of capital. Since the court below saw fit on substance-over-form principles not to be bound by the terminology used by Congress in the 1955 Act, it likewise should not have felt itself bound to assume that Class C stock earns no return merely because no return was expressly stated.[22]

[22] *Amicus* contended below (see R. 350–351 n. 6) that the government's failure to appeal from the district court's decision that patronage dividends are not income when received to the extent of their par value (see n. 9, *supra*) is inconsistent with the government's position that the cost of purchased Class C stock is nondeductible. But the question when a return is to be taken into income by accrual basis taxpayers like respondents turns on when all events have occurred to fix the taxpayers' right to the income. Treasury Regulations on Income Tax (1954

To be sure, the type of return earned on Class C stock is unusual. Unlike a typical stock investment which, at least in theory, offers the possibility of an unlimited return each year, so long as the investment is maintained, the maximum eventual amount of the return on Class C stock is fixed in a single year—the year in which the investment is made—by reference to that year's earnings. At the end of that year, the total amount which the stockholder will ultimately receive in cash is known, and is an amount in excess of its investment. It is the sum of (1) the face amount of that year's purchased Class C stock (its original investment), (2) the face amount of that year's patronage dividend Class C stock and (3) the amount of that year's allocated surplus credit. Thereafter, the stockholder in substance owns a non-interest bearing security, purchased at a discount price equal to the cost of the purchased Class C stock, with a face amount equal to the total amount which the stockholder will ultimately receive in cash. Its investment grows in value through the mere passage of time, and thus produces a return to the stockholder. Cf. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54.

The unusual characteristics of the return earned by Class C stock are a reflection of the fact, recognized by Judge Godbold in his dissenting opinion below (R. 358–359), that the investment made by a member in its cooperative is in many respects *sui generis*, and

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Code), Section 1.451–1(a). The question before this Court turns on the different issue whether respondents' purchases of Class C stock resulted in the creation of an asset. Compare *Commissioner* v. *Lincoln Savings and Loan Association*, *supra*.

is not exactly comparable to any other investment, be it loan, corporate stock or otherwise. But given the fact that the banks are cooperatives rather than ordinary corporations, the different way in which the banks divide their profits is immaterial. All that matters is that, in substance, purchasers of Class C stock have the opportunity to earn a return on the funds they invest.[23]

2. The stock has intrinsic value

Apart from any patronage dividends and allocated surplus credits arising from their purchase of Class C stock, farmer cooperatives stand to derive other benefits grounded in the intrinsic value of the stock as a capital contribution to a cooperative under the plan established by Congress. See R. 372 (dissenting opinion).

While patronage dividends and allocated surplus credits are the "benefits * * * more easily perceived because in the more conventional garb of dollars" (R. 369 (dissenting opinion)), ownership in the bank conferred by Class C stock involves other benefits and values. Respondents are in a position to obtain lower interest rates on their borrowings. Furthermore, their decision to

[23] Of course, there is a possibility, somewhat remote, that a cooperative will earn no return on its Class C stock if the bank is unprofitable, or even that it will suffer a loss on the stock. This possibility does not make the stock any less an asset, but rather emphasizes that it is an equity interest. See *Warren* v. *King*, 108 U.S. 389, 399. Likewise, the uncertainty as to the precise future time when benefits will be received is in no way inconsistent with treatment of purchased Class C stock as an asset. Compare *Commissioner* v. *Lincoln Savings and Loan Association*, *supra*.

capitalize the bank for their exclusive use has given them great financial power "through ultimate substantial ownership of the established, fully capitalized, staffed, and accepted financial institution" (R. 368 (dissenting opinion)). At the present time the actual control of the banks is shared with the government, since the government was for so many years the chief source of the banks' capital. But the substitution of cooperative for government capital has brought the banks a long way toward the eventual goal of member control (R. 164–168).[24] In actual fact, as the banks have retired more government stock, their members have achieved greater operational and voting control over them.[25]

In answer to respondents' contention below that only the government and the banks benefit from the

[24] The banks themselves realize, however, that "[j]ust as commercial banks have Governmental supervision," so they will also always have such supervision (R. 181).

[25] Cooperatives were entitled to elect one member of the bank's seven-man board of directors before 1967, but are now entitled to elect two members. The Land Bank and Production Credit Associations elect four of the other members, while one member is appointed by the Farm Credit Administration Governor. (R. 144–145, 168, 175–176, 181; Sec. 5(d)(2)(C) of the Farm Credit Act of 1937, Appendix B, *infra*, pp. 59–61.) During most of the years here in issue, respondents each had a director on the board (R. 226–227). The regional bank boards now elect 12 of the 13 Central Bank board members, the thirteenth being appointed by the Farm Credit Administration Governor (Sec. 31(a); R. 179–180). Before 1960, only three of the then seven-man Central Bank board were elected by regional banks and their members (Sec. 31 of the 1933 Act, as amended by Sec. 104 of the 1955 Act, 69 Stat. 655, 659–660; R. 175). The regional banks, together with the Land Bank and Production Credit Associations, also elect nominees, appointable by the President, for 12 of the 13 positions on the Federal Farm Credit Board (Sec. 4(a), (d), Farm Credit Act of 1953, Appendix B, *infra*, pp. 63–64).

required capital contributions in the form of Class C stock, we quote the colloquy between the president of a bank and the originator of the banks' revolving fund capitalization system, Mr. S. D. Sanders (R. 166):

> Some of the presidents doubted that the [revolving capitalization] plan would work. As one president said, the members of the cooperatives in his district "want all of the control and want everything delivered to them and they give nothing." They had this attitude toward both their local cooperative and the bank for cooperatives.
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> To this Mr. Sanders said: "In my way of thinking the philosophy of those men is very unsound all the way through. All interested in the farmers' welfare must recognize that no one on earth is going to change the status of the farmer but the farmer himself, and must realize that the bank for cooperatives is a business institution and requires capital, and furthermore that the capital must be furnished by the farmers (through their cooperatives) if they expect to have control of their credit system. That is just good common sense."

These capital contributions—the Class C stock purchases—have also enabled members to obtain many unique and valuable services from the banks. Contrary to the opinion of the Fifth Circuit majority (R. 352), member-cooperatives do not receive all services furnished by the New Orleans Bank merely by purchasing the first $100 eligibility share.[26] True, the bank

[26] Each shareholder in the Banks for Cooperatives has only one vote, regardless of the number of shares it owns, unlike a common stockholder in an ordinary corporation. But this characteristic is one of the distinguishing features of a co-

will "[w]ithin the limitations of its staff * * * work with any farmer cooperative * * * whether a stockholder or not * * *" (R. 179). But this offer is a type of promotional service given to farmer cooperatives to insure that they will develop and prosper and thus use the lending resources of the banks (R. 144, 160–161).

The great majority of the types of services rendered by the banks, including budgeting, financial planning, operating trend analysis, credit policies, and auditing standards (R. 160–161, 179), are given in connection with loans taken out by the members. For example, a New Orleans Bank Annual Report (R. 144) states that "[a]s a loan service the bank continues to make

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operative, and is necessary because each shareholder is also a customer of the cooperative. See *Keystone Automobile C. Cas. Co.* v. *Commissioner*, 122 F. 2d 886, 889–890 & n. 6; *Frost* v. *Corporation Commission*, 278 U.S. 515, 536–537 (Brandeis, J., dissenting); Packel, *The Law of Cooperatives* (3d ed.), pp. 68, 85–86, 138–140; see also Sec. 15 of the Agricultural Marketing Act, as amended by Section 12 of the Farm Credit Act of 1935, Appendix B, *infra*, p. 47. The fact that respondents have given up greater voting rights for the opportunity to share in the possibly greater benefits offered by a cooperative enterprise surely cannot mean that their Class C common stock is not a valuable asset. Transferability of the common stock of a cooperative is also more limited than in the case of the stock of an ordinary corporation. This limitation is grounded in the cooperative principle requiring the business to be owned principally by patrons interested in receiving satisfactory and inexpensive service, rather than by non-patron investors interested in maximum profits directly from their investments in the cooperative. In the absence of the limitation, a conflict of interest may develop between patrons and investors. Nieman, *Revolving Capital in Stock Cooperative Corporations*, 13 Law and Contemporary Problems, p. 396 & n. 12; see Packel, *supra*, pp. 127–129; Evans and Stokdyk, *The Law of Agricultural Cooperative Marketing*, (1937), pp. 58–65.

regular field visits to *borrowing cooperatives* to the extent possible with available personnel." (Emphasis added.) Another Banks for Cooperatives publication summed up the matter of services as follows (R. 179): "In short, the Banks for Cooperatives provide farmer cooperatives a complete and specialized credit service which *gives the money they lend* extra value." (Emphasis added.) The court of appeals' statement (R. 352), that "the right to Bank services is established by the purchase of the initial qualifying shares," is erroneous to the extent that it implies that members with one share of stock receive services from the bank as extensive as those received by large and frequent borrowers and Class C stock purchasers.[27]

It does not follow from the fact that payments for Class C stock can be viewed as payments for services that the stock is without long-term value, and that the payments are thus merely a current cost of doing business. The stock's long-term value would be clear, we submit, if Congress had required member-cooperatives to subscribe to a large amount of stock in the Banks for Cooperatives as a condition to joining and becoming eligible for their many services—including the right to borrow money—without regard to the amount they might borrow. The stock is no less valuable because Congress has keyed the time and amount of the stock subscription to the loan and interest billings, in all likelihood for the convenience of members (R. 366 (dissenting opinion)).

[27] The district court made no findings with respect to the services provided by the Banks for Cooperatives.

Respondents (Br. in Opp. 8–9) and the courts below (R. 344, 351–352) stress the differences between the Class C stock of the banks and the stock of an ordinary corporation, and have concluded that, while the latter is valuable, the former is not. But these differences are not adequate to support the conclusion. The primary difference between the common stock of a cooperative and that of an ordinary corporation is that common stock ownership in a cooperative does not, in and of itself, entitle one to a share in the distribution of each year's profits. A cooperative stockholder must normally in any year fulfill the additional requirement of patronizing the cooperative. Its share of the profits pool will then consist of the proportion its patronage bears to the total patronage of the cooperative in that year. In the case of the Banks for Cooperatives, this seeming inequality is alleviated by the fact that common stock ownership is itself proportionate to each member's yearly patronage. Unlike cooperatives, stockholders in an ordinary corporation obtain what a leading cooperative law commentator has termed "entrepreneur profit," that is, a share of the profits of the corporation in each year based on total stock owned. See Packel, *The Law of Cooperatives* (3d ed.), pp. 2–3, quoted by the dissent below (R. 360–361); see also *Frost v. Corporation Commission,* 278 U.S. 515, 536–537 (Brandeis, J., dissenting). But in a cooperative, the members must provide the capital for the venture, and the different way in which the profit of a cooperative corporation is allocated does not make the member's stock any less capital or any less valuable than stock in an ordinary corporation, especially in view of the other

long-term service benefits which a member derives from the capitalization of a cooperative corporation.

It is a basic income tax principle that one may not deduct a contribution to an ordinary corporation's capital as an ordinary and necessary business expense,[28] as a loss,[29] or as a worthless debt,[30] because the stock received in return is a capital item having a useful life extending substantially beyond the close of the taxable year. The same principle would preclude the deduction of such a contribution as interest, because only interest "paid or accrued within the taxable year * * *" is deductible under Code Section 163. Since, as we have shown, the cooperative stock here in question, like the stock of an ordinary corporation, has continuing value, capital contributions to the Banks for Cooperatives should not be currently deductible.[31]

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[28] *E.g.*, *Island Petroleum Co.* v. *Commissioner*, 17 B.T.A. 1, 10–11, affirmed, 57 F. 2d 992, 994–995 (C.A. 4), certiorari denied, 287 U.S. 646; *Wilson* v. *Commissioner*, 40 T.C. 543, 551.

[29] *E.g.*, *Lutz* v. *Commissioner*, 2 B.T.A. 484; *Paxton* v. *Commissioner*, 7 B.T.A. 92.

[30] *E.g.*, *In re Park's Estate*, 58 F. 2d 965 (C.A. 2), certiorari denied, 287 U.S. 645.

[31] See *Paducah & Illinois Railroad Co.* v. *Commissioner*, 2 B.T.A. 1001, 1006–1007; *874 Park Avenue Building Corporation* v. *Commissioner*, 23 B.T.A. 400. It is settled law that contributions to capital do not constitute income either to an ordinary corporation or to a cooperative. See Section 118 of the Internal Revenue Code; *Garden Homes Co.* v. *Commissioner*, 64 F. 2d 593 (C.A. 7); *Cambridge Apartment Building Corp.* v *Commissioner*, 44 B.T.A. 617; *Farmers Cooperative* v. *Birmingham*, 86 F. Supp. 201, 236–237 (N.D. Iowa).

D. EVEN IF THE STOCK HAS ONLY NOMINAL VALUE, ITS ENTIRE COST MUST BE CAPITALIZED

Unless the Court rejects all of our preceding arguments, there will be no need to reach the question whether, if the Class C stock purchased by respondents has only nominal value, its entire cost nevertheless must be capitalized. Our position is, however, that even if this is the case, no deduction is justified.

As a preliminary matter, it is important to note that Class C stock has limited value if it is viewed, as respondents contend it should be, as conferring upon them nothing more than the right to a return of their payments at an indefinite future time. The value may not be susceptible of quantification, but since one would rather have the right than not have it—all other things being equal—it is fair to conclude that the right has a value, whatever it might be.

With this in mind, we turn again to Section 1.461–1 (a)(2) of the Treasury Regulations. It provides that "any expenditure which results in the creation of an asset having a useful life extending substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred." Nothing in the Regulations suggests that, for the rule of nondeductibility to apply, the asset created must have a value equal to or greater than the expenditure made. All that is required is that an item of value be created. An item of limited value fits within this description.

Until the decision of the Court of Claims in *Penn Yan Agway, supra,* it had uniformly been held that

where one pays more for an asset than it is worth—a situation which in our view does not exist here—realization of any loss must await a sale or other disposition, or complete worthlessness.[32] The court below felt free to depart from this rule for two reasons. First, following the opinion of the Court of Claims in *Penn Yan Agway* (417 F. 2d at 1379), the court felt that it would be unfair to apply the rule where, as here, the restrictions on transferability precluded respondents from selling their stock and realizing the loss (R. 355). Second the court stated (R. 355) that the cases establishing the rule were distinguishable, since in those cases the taxpayers had been the victims of bad bargains.

These considerations do not justify a departure from the familiar principle that only losses "actually sustained during the taxable year" may be deducted, and that "a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed or completed transactions and as fixed by identifiable events occurring in such taxable year." Treasury Regulations on Income Tax, Section 1.165–1 (a) and (d)(1). Indeed, the second consideration referred to by the court of appeals would seem to place respondents in a weaker position to claim relief

[32] See, *e.g.*, *Montana Power Co.* v. *United States*, 159 F. Supp. 593, 594 (Ct. Cl.), certiorari denied, 358 U.S. 842; *Booth Newspapers, Inc.* v. *United States*, 303 F. 2d 916, 922 (Ct. Cl.); *Koppers Co.* v. *United States*, 278 F. 2d 946, 949 (Ct. Cl.); *Dresser* v. *United States*, 55 F. 2d 499, 512 (Ct. Cl.), certiorari denied, 287 U.S. 635; *Chase Candy Co.* v. *United States*, 126 F. Supp. 521 (Ct. Cl.).

on some equitable ground than those taxpayers who were the victims of bad bargains.

Nor can respondents escape the rule requiring the realization of losses by claiming interest and expense deductions under Sections 163(a) and 162(a). This Court has repeatedly recognized that the cost of an asset may be recovered only when a loss is sustained, unless the asset is subject to depreciation or amortization. See, *e.g.*, *Woodward* v. *Commisioner*, 397 U.S. 572, 574–575; *Commissioner* v. *Tellier*, 383 U.S. 687, 689–690; *Helvering* v. *Winmill*, 305 U.S. 79.[33]

[33] Respondents are not helped by cases purporting to apply the rationale of *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, and permitting ordinary loss treatment on the sale of corporate stock, on the ground that the stock was purchased and held incident to the taxpayer's business, rather than as an investment. *E.g.*, *Booth Newspapers, Inc.* v. *United States*, 303 F. 2d 916 (Ct. Cl.); *Western Wine & Liquor Co.* v. *Commissioner*, 18 T.C. 1090. Apart from the question whether such ordinary loss treatment is within the proper scope of *Corn Products*, the issue in these cases is whether the stock sold was a *capital* asset within the meaning of Section 1221. (It was assumed in each case that the stock was an asset.) Here, on the other hand, there has been no sale, and the issue is whether the stock purchased is an asset, not whether it is a capital asset. We read *McMillian Mortgage Co.* v. *Commissioner*, 36 T.C. 924, as also involving the capital asset question—there in the context of sales of FNMA stock acquired in exchange for mortgages. To the extent that *Ancel Greene & Co.* v. *Commissioner*, 38 T.C. 125, is contrary to our position, it would also seem contrary to *Helvering* v. *Winmill*, *supra*, which recognizes that a dealer in securities must capitalize their cost on acquisition. But *Greene* can be harmonized with *Winmill* by reading it as involving realized losses sustained on the exchange of mortgages for stock, rather than a purchase of stock. At all events, both the *McMillian* and *Greene* decisions are of limited precedential value, since ordinary deductions upon acquisition of FNMA stock in exchange for mortgages are now permitted

F. THE USURY AND BONUS PAYMENT CASES RELIED ON BY THE COURT BELOW DO NOT SUPPORT RESPONDENTS' CONTENTION THAT PAYMENTS FOR CLASS C STOCK CONSTITUTE INTEREST

The court below (R. 356–357 & n. 31) and the Court of Claims in *Penn Yan Agway* (417 F. 2d at 1379) relied heavily on opinions by the Tenth Circuit in two usury cases (*Oil City Motor Co.* v. *C.I.T. Corp.*, 76 F. 2d 589, 591, and *Memorial Gardens of Wasatch, Inc.* v. *Everett Vinson & Associates*, 264 F. 2d 282, 285), for the proposition that—

> if as a condition to the making of a loan at an apparently permissible rate of interest, the lender requires the borrower to sell property to him at less than its value or to purchase property from him at an excessive price, the difference represents interest and will be taken into account in determining whether the transaction is usurious. * * *

But this principle has no application here because the Banks for Cooperatives do not require their members to "purchase property from * * * [them] at an excessive price." As we have shown, the Class C stock required to be purchased represents the provision of capital for the banks, and, in substance in the light of the cooperative scheme of business organization, bears a return and also has intrinsic value. Moreover, the courts have consistently held the principle relied on below inapplicable to stock payments by borrowers to cooperative lending institutions similar to the Banks for

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only by virtue of a special provision of the Code (Section 162(d)), specifically limited to these transactions, and excepting them from the rule otherwise applicable to the costs of acquiring an asset.

Cooperatives. These holdings actually support our position that the payments in question constitute capital contributions rather than interest.

Building and Loan Ass'n v. *Price,* 169 U.S. 45, involved a contract by a building and loan association, a type of cooperative (see Packel, *The Law of Cooperatives* (3d ed.), p. 22–23),[34] to lend $2,000 at the maximum allowable legal interest rate, on condition that the borrower contemporaneously subscribe to $4,000 par value of the association's stock. The contract provided that payments on the stock subscription were to be made simultaneously with the interest payments on the loan. As in the instant case, the stock payments served as collateral for the loan. This Court held that the payments on the stock did not constitute interest, and that the loan therefore was not usurious, concluding (pp. 53–54):

> The stock is not, as is claimed by counsel for appellee, a mere fiction. * * * [The owner's] position of shareholder is entirely separate from his position of borrower from the company.

In *Gunby* v. *Armstrong,* 133 Fed. 417, 430–432 (C.A. 5), a similar loan-stock purchase agreement of a building and loan association was involved. As in the instant case, there existed different classes of stock, some of which were noninterest bearing. Noting that the loan agreement "on its face * * * [was] for legal interest

[34] In Massachusetts, building and loan associations are often referred to as "cooperative banks." See, *e.g.*, *Lexington Co-operative Bank* v. *Commissioner of Banks*, 327 Mass. 624, 100 N.E. 2d 18; *Commissioner of Banks* v. *Fitchburg Co-operative Bank*, 329 Mass. 401, 108 N.E. 2d 542.

only," the court stated that the borrower had not borne his burden of proving " 'that there was some corrupt agreement, or device or shift, to cover usury * * *' ", quoting *United States Bank* v. *Waggener*, 9 Pet. 378, 399. It held that the two contracts of loan and stock subscription were to be regarded as "separate and distinct" and, in consequence, that the loan was not usurious. While there was at first some confusion among the state courts in interpreting such loan-stock subscription agreements, they have almost all adopted the conclusion set forth in the cases discussed above, that, in the absence of a showing of a corrupt agreement or device to mask usury, payments on a stock subscription are not to be regarded as adding to the amount of interest paid pursuant to the loan agreement.[35]

The Tenth Circuit decisions are not inconsistent with the building and loan association cases. In *Memorial Gardens, supra,* the court did not state the general principle upon which respondents rely as an absolute. Rather, it qualified the principle (264 F. 2d at 284–285) with the requirement that the borrower who is required to purchase property in connection with a

[35] See, *e.g.*, *Pacific States Savings, Loan & Bldg. Co.* v. *Green*, 123 Fed. 43 (C.A. 9), and *Fidelity Sav. Ass'n* v. *Bank of Commerce*, 12 Wyo. 315, 75 Pac. 448, which discuss the numerous cases; compare *Bedford* v. *Eastern Building and Loan Ass'n*, 181 U.S. 227, 242–243 (interpreting New York law), *Manship* v. *New South Building & Loan Ass'n*, 110 Fed. 845 (SD. Miss.), and *Bank of Loudon* v. *Armor*, 90 Miss. 709, 44 So. 66 (interpreting Mississippi law), with *National Mutual B. & L. Assn.* v. *Brahan*, 193 U.S. 635 (noting the earlier Mississippi law); see generally 12 C.J.S., *Building and Loan Associations*, Sec. 78b.

loan must show that the sale of the property was "a subterfuge to cover up the true intent of the parties and that it was * * * the purpose or intent of the parties that the transaction should, in fact, be one for the loan or forbearance of money * * *." On the facts, the court held that the borrower had not made the required showing. In *Oil City, supra,* the court merely recognized the general proposition that a requirement that a borrower purchase property at an inflated price as a condition for a loan might constitute usury, but had no need to apply the principle in any way, and thus no occasion to spell out the qualifications to which the principle is subject.

In *Continental Savings & Building Ass'n* v. *Wood,* 33 S.W. 2d, 770, 772 (Tex. Civ. App.), the court held that the statutes regulating building and loan association loan agreements and stock subscriptions did not constitute a "device" for allowing usurious interest. It refused to presume a legislative intention to violate state constitutional and statutory usury proscriptions. Any contention that the interest and stock payments here were not separate items within the understanding of the parties also must fail, since the loans and stock purchases were made pursuant to statutory and administrative directives clearly evidencing that the transactions were separate.[36] Compare

[36] Respondents (Br. in Opp. 3) and the court of appeals (R. 349) refer to the Class C stock payments as "interest override." But this term nowhere appears in the legislation enacted by Congress or in the pertinent administrative regulations. As the President of the New Orleans Bank for Cooperatives, who was respondents' witness, testified with respect to the origin of the term (R. 256): "We coined it in the Bank (laugh) and our

Sec. 8 of the Agricultural Marketing Act, Appendix B, *infra*, p. 47, and Farm Credit Adm. Regs., Sec. 70.90, Appendix B, *infra*, pp. 64–65, with Sec. 42(a) of the Farm Credit Act of 1933 and Farm Credit Adm. Regs., Sec. 70.142, *supra*.

The bonus payment cases relied on by the court below (R. 356 & n. 30) [37] likewise are not relevant to the question here. As recognized by the district court in *M.F.A. Central Cooperative, supra*, 286 F. Supp. at 959:

> These [bonus payment] cases are distinguishable from the present matter, because in each * * * the debtor parted with the additional money and received nothing in return other than the use of the lender's money. In the present situation, * * * [the borrower] parted with the additional money and received stock in the * * * Bank, which had a corresponding face value.

This distinction is one which is commonly made in the building and loan association cases, payments for stock being consistently treated as capital investments, while "premiums" paid for the use of the money

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borrowers, I think, picked it up also." The self-serving phrase cannot serve as a substitute for the congressional judgment regarding the nature of Class C stock.

[37] *Wiggins Terminals, Inc.* v. *United States*, 36 F. 2d 893 (C.A. 1); *L–R Heat Treating Co.* v. *Commissioner*, 28 T.C. 894; *Court Holding Co.* v. *Commissioner*, 2 T.C. 531, 536, reversed on other grounds, 143 F. 2d 823 (C.A. 5), court of appeals reversed and Tax Court affirmed on other grounds, 324 U.S. 331. The Court of Claims relied on the same cases in *Penn Yan Agway*, *supra*, 417 F. 2d at 1379.

are often held to constitute usurious interest if not specifically allowed by statute.[38]

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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[38] See, *e.g.*, *Douglass* v. *Kavanaugh*, 90 Fed. 373 (C.A. 6); see generally Annotation, Non-compliance with conditions prescribed by statute as affecting validity of contract, under usury laws, for payment of premium on loan of building and loan association," 74 A.L.R. 973; Sundheim, *Law of Building and Loan Associations* (1933), pp. 150–151; 13 Am. Jur. 2d, Building and Loan Associations, Sec. 59; 12 C.J.S., *supra*, Sec. 73b.

APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(*a*) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

* * * * *

SEC. 163. INTEREST.

(*a*) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

SEC. 1.461–1 *General rule for taxable year of deduction.*

(*a*) *General rule.*—(1) * * *

(2) *Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of

such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461–2. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

* * * * *

APPENDIX B

Agricultural Marketing Act, c. 24, 46 Stat. 11:

SEC. 8 [as amended by Sec. 109, Farm Credit Act of 1955, c. 785, 69 Stat. 655, 662]. (a) Loans to cooperative associations made by any bank for cooperatives shall bear such rates of interest as the board of directors of the bank shall from time to time determine with the approval of the Farm Credit Administration, but in no case shall the rate of interest exceed 6 per centum per annum on the unpaid principal of a loan.

* * * * *

[12 U.S.C. 1141f.]

SEC. 15 [as amended by Sec. 12, Farm Credit Act of 1935, c. 164, 49 Stat. 313, 317]. (*a*) As used in this Act, the term "cooperative association" means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services: *Provided, however,* That such associations are operated for the mutual benefit of the members thereof as such producers or purchasers and conform to one or both of the following requirements:

First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; and

Second. That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum.

* * * * *

[12 U.S.C. 1141j.]

Farm Credit Act of 1933, c. 98, 48 Stat. 257:

SEC. 2 [as amended by Sec. 105(a), Farm Credit Act of 1956, c. 741, 70 Stat. 659, 665]. The Governor of the Farm Credit Administration, hereinafter in this Act referred to as the "Governor", is authorized and directed to organize and charter twelve banks to be known as "banks for cooperatives". One such bank shall be established in each city in which there is located a Federal land bank. The members of the several farm credit boards of the farm credit districts provided for in section 5 of the Farm Credit Act of 1937, as amended, shall be ex officio the directors of the respective banks for cooperatives. Such directors shall have power, subject to the approval of the Governor, to employ and fix the compensation of such officers and employees of such banks as may be necessary to carry out the powers and duties conferred upon such banks under this Act.

* * * * *

[12 U.S.C. 1134.]

SEC. 31. [as amended by Sec. 1, Act of June 11, 1960, P.L. 86–503, 74 Stat. 197]. BOARD OF DIRECTORS OF THE CENTRAL BANK.—(a) The Central Bank for Cooperatives shall have thirteen directors, one from each of the twelve farm credit districts and a director-at-large. The director-at-large shall be appointed by the Governor by and with the advice and consent of the Federal Farm Credit Board. Initially, directors from six of the farm credit districts shall be appointed by the Governor by and with the advice and consent of the Federal Farm Credit Board and directors from the other six farm credit districts shall be elected by the board of directors of the regional bank for cooperatives in the district. The Farm Credit Administration shall designate the districts which shall be represented by appointed directors and which by elected directors. Except as otherwise required under subsections (b) and (c) of this section, a director appointed

for a district shall be succeeded by a director elected in the same district and a director elected in a district shall be succeeded by a director appointed for the same district. The term of office of a director shall be three years, except that the terms of office for directors other than the director-at-large which begins January 1, 1961, shall be one year, two years, and three years, divided equally among elected and appointed directors as designated by the Farm Credit Administration. The Farm Credit Administration shall prescribe rules and regulations and take all other action necessary to permit the elections required by this section.

(b) Whenever, as of June 30, of any year, the Farm Credit Administration determines that the sum of the capital stock and subscriptions to the guaranty fund of the Central Bank held by persons other than the Governor on behalf of the United States and surplus and reserve accounts of said bank equals or exceeds 66-2/3 per centum of the total capital stock, subscriptions to the guaranty fund and surplus and reserve accounts of said bank, the directors from the farm credit districts for the terms beginning the next succeeding January 1 shall all be elected by the board of directors of the regional bank for cooperatives in the respective districts.

* * * * *

[12 U.S.C. 1134g.]

Sec. 36 [as amended by Sec. 103, Farm Credit Act of 1955, *supra,* and Sec. 2, Act of October 3, 1961, P. L. 87-343, 75 Stat. 758].

(*a*) *Application of Savings.*—Each bank for cooperatives, at the end of each fiscal year, shall determine the amount of its net savings after paying or providing for all operating expenses (including reasonable valuation reserves and losses in excess of any such applicable reserves) and shall apply such savings as follows: (1) To the restoration of the amount of the impairment, if any, of capital stock, as determined by

its board of directors; (2) 25 per centum of any remaining savings shall be used to create and maintain a surplus account; (3) if said bank shall have outstanding capital stock held by the United States during the whole or any part of the fiscal year, it shall next pay to the United States as a franchise tax, a sum equal to 25 per centum of its net savings then remaining, not exceeding, however, a rate of return on such Government capital calculated at a rate equal to the computed average annual rate of interest on all public issues of public debt obligations of the United States issued during the fiscal year ending next before such tax is due, as certified to the Farm Credit Administration by the Secretary of the Treasury; (4) reasonable contingency reserves may be established; (5) dividends on class B stock may be declared as provided in section 42 (a) (2); and (6) any remaining net savings shall be distributed as patronage refunds as provided in subsection (b) of this section: *Provided,* That any patronage refunds received by a regional bank from the central bank shall be excluded from net savings of the regional bank for the purpose of computing such franchise tax. Amounts applied as provided in (2) and (4) above after the effective date of title I of the Farm Credit Act of 1955 shall be allocated on a patronage basis approved by the Farm Credit Administration. At the end of any fiscal year, any portion of the reserve established under (4) above which is no longer deemed necessary shall be transferred to the surplus account and, if the surplus account of any such bank for cooperatives exceeds 25 per centum of the sum of all its outstanding capital stock, the bank may distribute in the same manner as a patronage refund any part or all of such excess which has been allocated: *Provided,* That any surplus and contingency reserves shown on the books of the banks as of the effective date of title I of the

Farm Credit Act of 1955 shall not be distributed as patronage refunds. In making such distributions, the oldest outstanding allocations shall be distributed first. Wherever used in this Act, the words "surplus account" as applied to any bank for Cooperatives shall mean any surpluses and contingency reserves shown on the books of the banks as of the effective date of title I of the Farm Credit Act of 1955 and any amounts applied as provided in (2) above after the effective date of said title I. Said surplus account shall be divided to show the amounts thereof subject to allocation as provided in this section and may be further subdivided as prescribed by the Farm Credit Administration. In the event of a net loss in any fiscal year after providing for all operating expenses (including reasonable valuation reserves and losses in excess of any such applicable reserves), such loss shall be absorbed by: first, charges to allocated contingency reserves; second, charges to allocated surplus; third, charges to other contingency reserves and surplus; fourth, the impairment of class C stock; and fifth, the impairment of all other stock.

(*b*) *Patronage Refunds.*—The patronage refunds of each regional bank for cooperatives shall be paid in class C stock to borrowers, as defined by the Farm Credit Administration for the purposes of this subsection, during the fiscal year for which the refunds are declared. Patronage refunds of the Central Bank for Cooperatives shall be paid in class C stock to the regional banks for cooperatives upon the basis of interests held by the central bank in loans made by the regional banks and upon direct loans made by the central bank to cooperative associations; and any part of such refunds derived from such direct loans of the central bank shall be paid in class C stock issued to the regional bank or banks which issued to the bor-

rower the stock incident to the loans, or to a regional bank or banks designated by the Farm Credit Administration, and such bank or banks shall issue a like amount of class C stock to the borrowers. All patronage refunds shall be paid in the proportion that the amount of interest earned on the loans of each borrower bears to the total interest earned on the loans of all borrowers during the fiscal year.

(*c*) *Application of Assets on Liquidation or Dissolution.*—In the case of liquidation or dissolution of any bank for cooperatives, after the payment or retirement, as the case may be, first, of all liabilities; second, of all capital stock issued before the effective date of title I of the Farm Credit Act of 1955 held by cooperative associations at par, all class A stock at par, and all class B stock at par; and third, of all class C stock at par; any surpluses and contingency reserves existing on the effective date of said title I shall be paid to the holders of outstanding capital stock issues before the effective date of said title I, class A stock and class C stock pro rata, and any remaining surplus and contingency reserves shall be distributed to those entities to which they are allocated on the books of the bank. If it should become necessary to use any surplus or contingency reserves to pay any liabilities or to retire any capital stock, allocated contingency reserves and surplus shall be exhausted first in accordance with rules prescribed by the Farm Credit Administration.

(*d*) Notwithstanding any other provision of this Act, in the case of liquidation or dissolution of any present or former borrower from a bank for cooperatives, the bank, may, in accordance with rules and regulations prescribed by the Farm Credit Administration, retire and cancel any capital stock or allocated surplus and contingency reserves or other equity interest, in the bank owned by such borrower at the fair

book value thereof, not exceeding par, and, to the extent required, corresponding shares and allocations or other equity interests held by the regional bank in the central bank shall be retired.

[12 U.S.C. 1134*l*.]

* * * * *

SEC. 42 [as amended by Sec. 101, Farm Credit Act of 1955, *supra*]. (*a*) *Classes of Stock; Ownership; Voting Rights; Dividends; and Retirement of Stock.*—Except as provided in section 111 of the Farm Credit Act of 1955, each regional bank for cooperatives shall have the following classes of stock, all of which shall have a par value of $100 per share:

(1) Class A stock shall be issued to and held by the Governor of the Farm Credit Administration on behalf of the United States, and stock of such banks held by the Governor on the effective date of title I of the Farm Credit Act of 1955 shall be exchanged, share for share, for class A stock of the respective banks. Class A stock shall be nonvoting and no dividends shall be paid thereon. At the end of each fiscal year, each of such banks, subject to the provisions of sections 33 and 40, shall determine the amount of class A stock that shall be retired at par by that bank. The minimum amount of class A stock that shall be retired shall be the equivalent in dollar value of the amount of class C stock issued for that year, except that class C stock issued by a regional bank on account of class C stock issued to it by the central bank, class C stock issued by a regional bank in exchange for class B stock the proceeds of which were used to retire an equivalent amount of class A stock, and class C stock issued by a regional bank in exchange for capital stock of the bank outstanding on the effective date of title I of

the Farm Credit Act of 1955, shall not be included in such bank's calculation. Any amount of class A stock retired in excess of such minimum amount in one year may be used to reduce to that extent the amount of such stock required to be retired in any subsequent year. Funds from the retirement of class A stock shall be paid into the revolving fund authorized by the Agricultural Marketing Act, as amended, and shall continue to be available for the purchase of class A stock in the banks in accordance with sections 33 and 40.

(2) Class B stock may be issued in series and amounts approved by the Farm Credit Administration, and may be sold or transferred to any person subject to the approval of the issuing bank. Such stock shall be issued only at par and shall be nonvoting. Any bank may pay dividends of not to exceed 4 per centum per annum on class B stock if declared by the board of directors and approved by the Farm Credit Administration and if the surplus account of the bank, after payment of such dividends, will not be less than 25 per centum of the sum of all its outstanding capital stock. Dividends on class B stock shall not be cumulative, but no bank shall distribute in any year any of its net savings as patronage refunds as provided in section 36 (a) unless for that year a dividend of at least 2 per centum is declared and paid upon outstanding class B stock of the bank. Each series of class B stock shall be issued only with the approval of the Farm Credit Administration and shall carry on the face of each certificate a statement of the maximum dividend which may be declared and paid thereon and of the minimum dividend which shall be declared and paid thereon before the bank may distribute any of

its net savings as patronage refunds: *Provided,* That such maximum and minimum dividends may be the same amount. After all class A stock has been retired, class B stock may be called for retirement at par with the approval of the Farm Credit Administration and shall be called in such manner that the oldest outstanding stock at any given time will be retired first. Any holder of class B stock whose stock has been called for retirement may elect, with the approval of the issuing bank, to leave his stock in the bank subject to its being included in the next call for retirement.

(3) Class C stock, except as approved by the Farm Credit Administration and consented to by the issuing bank, may be issued only to banks for cooperatives and farmers' cooperative associations as defined in section 15 (a) of the Agricultural Marketing Act, as amended. Such stock may be issued in fractional shares, shall be issued at its fair book value not exceeding par, as determined by the bank, and no dividends shall be paid on it. Each holder of one or more shares of class C stock which is eligible to borrow from a bank for cooperatives shall be entitled to one vote only: *Provided,* That any such holder which within the period of two years next preceding a date, fixed by the Farm Credit Administration, prior to commencement of the voting has not been a borrower from a bank of which it holds class C stock shall not be entitled to vote. From time to time each bank for cooperatives shall obtain information concerning its class C stockholders to determine whether they continue to be eligible to borrow from the bank and to vote. Any class C stockholder found by the bank to be ineligible to borrow shall not be entitled to vote until its eligibility is

reestablished to the satisfaction of the bank. Whenever in section 5 of the Farm Credit Act of 1937, as amended, and section 4(a) of the Farm Credit Act of 1953, provision is made for a nomination or election by cooperatives which are stockholders or subscribers to the guaranty fund of any bank for cooperatives the term 'cooperatives which are stockholders or subscribers to the guaranty fund' or the equivalent of that term, shall mean such cooperatives which are eligible to vote. Each borrower from a bank for cooperatives shall be required to own at the time the loan is made at least one share of class C stock. The purchase price of such stock may be retained out of the loan. In addition, each borrower as defined by the Farm Credit Administration for purposes of this sentence, shall be required to invest quarterly in class C stock an amount equal to not less than 10 nor more than 25 per centum, as prescribed by the board of directors of the bank with the approval of the Farm Credit Administration, of the amount of interest payable by it to the bank during the calendar quarter. Payments for such stock shall be made quarterly or when the regular interest payments of the borrower are payable, but the stock shall be issued to the borrower as of the end of each fiscal year in the amount of the payments for stock made by it during the year. Each regional bank shall purchase at least one share of class C stock of the central bank. In addition, the regional bank shall be required to invest quarterly in class C stock of the central bank an amount equal to not less than 10 nor more than 25 per centum, as prescribed by the board of directors of the central bank with the approval of the Farm Credit Administration, of the amount of interest pay-

able by the regional bank to the central bank during the calendar quarter by reason of any interest purchased by the central bank in a loan made by the regional bank. Payments for such stock shall be made to the central bank and the stock shall be issued to the regional bank in the same manner, insofar as practicable, as is provided in this section for payments for and issuance of stock on account of loans by the regional bank in which the central bank does not purchase any interest. Subject to rules prescribed by the board of directors of the lending bank with the approval of the Farm Credit Administration a borrower may convert class B stock into class C stock for the purpose of making the investment in class C stock required by this paragraph. After retirement of all class A stock, class C stock also may be retired at par by calling the oldest outstanding class C stock, but class C stock that was issued for a fiscal year period shall not be called for retirement until all class B stock that was issued during or prior to that fiscal year has been called for retirement.

* * * * *

(c) *Lien on Stock.*—Except as hereinafter provided in the case of an association which is a direct borrower from the central bank, each bank for cooperatives shall have a first lien on all stock in the bank owned by each cooperative association as additional collateral for any indebtedness of such association to the bank. In the case of an association which is a direct borrower from the central bank, the central bank shall have a first lien on any amount of class C stock which the borrowing association owns in any regional bank on account of direct loans of such association from the central bank; and the regional bank shall have a lien on such stock junior only to the lien of the central bank. In

any case where the debt of a borrower is in default, the bank may, in accordance with regulations of the Farm Credit Administration, retire and cancel all or a part of the stock of the defaulting borrower at the fair book value thereof, not exceeding par, in total or partial liquidation of the debt, as the case may be, and, to the extent required, corresponding shares held by a regional bank in the central bank shall be retired.

* * * * * *

[12 U.S.C. 1134d.]

SEC. 63 [as amended by Sec. 105(o), Farm Credit Act of 1968, *supra*]. The Central Bank for Cooperatives, and the Production Credit Associations, and Banks for Cooperatives, organized under this Act, and their obligations, shall be deemed to be instrumentalities of the United States, and as such, any and all notes, debentures, bonds, and other such obligations issued by such banks, or associations shall be exempt both as to principal and interest from all taxation (except surtaxes, estate, inheritance, and gift taxes) now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority. Such banks, and associations, their property, their franchises, capital, reserves, surplus, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority; except that any real property and any tangible personal property of such banks and associations and corporations shall be subject to Federal, State, Territorial, and local taxation to the same extent as other similar property is taxed. The exemption provided herein shall not apply with respect to any production credit association or its property or income after the class A stock held in it by the Governor has been retired, or with respect to any bank for cooperatives or its

property or income after the stock held in it by the United States has been retired.

[12 U.S.C. 1138c.]

Farm Credit Act of 1937, c. 704, 50 Stat. 703:

SEC. 5 [as amended by Sec. 15, Farm Credit Act of 1953, c. 335, 67 Stat. 390, 397, and Sec. 104(h), Farm Credit Act of 1959, P.L. 86–168, 73 Stat. 384, 387].

* * * * *

(*d*) (1) The member of the farm credit board of each farm credit district known as the "third district director", who is in office on the effective date of the Farm Credit Act of 1953, shall serve as such until his term of office expires. Thereafter, there shall be no member of the district farm credit board to be known as the "third district director".

(2) Notwithstanding the above provision with respect to the appointment of district directors, one additional member of said board shall be elected by each of the groups aforesaid (Federal land bank associations and borrowers through agencies, production credit associations, and cooperatives which are stockholders or subscribers to the guaranty fund of the regional bank for cooperatives of the district), and serve in lieu of a district director, under the following circumstances and conditions:

* * * * *

(C) Whenever, as determined by the Farm Credit Administration, the sum of the capital stock and subscriptions to the guaranty fund held by cooperatives which are stockholders or subscribers to the guaranty fund of a regional bank for cooperatives, surplus and reserves of said bank shall equal or exceed 66⅔ per centum of the total capital stock, subscriptions to the guaranty fund, surplus and reserves of said bank as of the date three months before the expiration of the term of office of the dis-

trict director (or third district director) whose term next expires, the successor to such director shall be elected by the cooperatives which are stockholders or subscribers to the guaranty fund of said bank in the manner herein provided, shall be known as an elected director, and successors to that office shall be so elected and known from term to term while such conditions obtain: *Provided,* That if and when, as determined by the Farm Credit Administration, such conditions do not obtain as of the date three months before the expiration of the term of office of any director so elected under the provisions of this subparagraph, the successor to such director shall be appointed by the Governor of the Farm Credit Administration by and with the advice and consent of the Federal Farm Credit Board, shall be known as a district director, and successors to that office shall be so appointed and known from term to term for such terms as appointment is not precluded by the election of an additional director by one of the groups aforesaid as herein provided: *Provided further,* That such cooperatives which are stockholders or subscribers to the guaranty fund of said bank shall again and from time to time elect one additional director as aforesaid if and when the required conditions named in this subparagraph shall be determined to obtain as aforesaid: *Provided further,* That at no time and under no conditions shall there be in office less than one or more than two members of said board who are serving by election of any one of the groups aforesaid (Federal land bank associations and borrowers through agencies, production credit associations, and cooperatives which are stockholders or subscribers to the guaranty fund of the regional bank for cooperatives of the district): *And provided further,* That if two or more of said groups shall, under the terms and provisions hereof, become qualified to elect an additional director pend-

ing the expiration of the term of office of the district director (or third district director) whose term next expires, preference shall be given, first to Federal land bank associations and borrowers through agencies, next to production credit associations, and next to cooperatives which are stockholders or subscribers to the guaranty fund of the regional bank for cooperatives, to elect an additional director as herein provided as the terms of office of district directors, including the third district director if he be still in office, expire.

* * * * *

(*e*) At least two months before an election of an elected director the Farm Credit Administration shall cause notice in writing to be sent to those entitled to nominate candidates for such elected director. In the case of an election of a director by Federal land bank associations and borrowers through agencies, such notice shall be sent to all Federal land bank associations and borrowers through agencies in the district; in the case of an election by production credit associations, such notice shall be sent to all production credit associations in the district; and in the case of an election by cooperatives which are stockholders or subscribers to the guaranty fund of the bank for cooperatives of the district, such notice shall be sent to all cooperatives which are stockholders or subscribers to the guaranty fund at the time of sending notice. After receipt of such notice those entitled to nominate the director shall forward nominations of residents of the district to the Farm Credit Administration. The Farm Credit Administration shall, from the nominations received within thirty days after the sending of such notice, prepare a list of candidates for such elected director consisting of the ten nominees receiving the highest number of votes.

(*f*) At least one month before the election of an elected director the Farm Credit Admin-

istration shall mail to each person or organization entitled to elect the elected director the list of the ten candidates nominated in accordance with the preceding paragraph of this section. In the case of an election of a director by Federal land bank associations and borrowers through agencies, the directors of each land bank association shall cast the vote of such association for one of the candidates on the list. In voting under this section each such association shall be entitled to cast a number of votes equal to the number of stockholders of such association and each borrower through agencies shall be entitled to cast one vote. In voting under this section each production credit association shall be entitled to cast a number of votes equal to the number of the class B stockholders of such association. In voting under this section each cooperative which is a holder of stock in, or a subscriber to the guaranty fund of, the bank for cooperatives shall be entitled to cast one vote. The votes shall be forwarded to the Farm Credit Administration and no vote shall be counted unless received by it within thirty days after the sending of such list of candidates. In case of a tie the Farm Credit Administration shall determine the choice. The nominations from which the list of candidates is prepared, and the votes of the respective voters, as counted, shall be tabulated and preserved and shall be subject to examination by any candidate for at least one year after the result of the election is announced.

* * * * *

[12 U.S.C. 640d, 640e, 640f.]

Farm Credit Act of 1953, c. 335, 67 Stat. 390:

* * * * * *

SEC. 2. It is declared to be the policy of the Congress to encourage and facilitate increased borrower participation in the manage-

ment, control and ultimate ownership of the permanent system of agricultural credit made available through institutions operating under the supervision of the Farm Credit Administration, and the provisions of this Act shall be construed in keeping with this policy. The Federal Farm Credit Board hereinafter provided for shall within one year after appointment make recommendations to the Congress of means, supplemental to those provided by this Act, of carrying into effect such declared policy, including, but not limited to, means of increasing borrower participation in ownership of the Federal Farm Credit System to the end that the investment of the United States in the Federal intermediate credit banks, production credit corporations, Central Bank for Cooperatives, and regional banks for cooperatives may be retired.

[12 U.S.C. 636a.]

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SEC. 4 [as amended by Sec. 402, Farm Credit Act of 1955, *supra*, and Sec. 104(h), Farm Credit Act of 1959. *supra*]. (a) There shall be established, in the Farm Credit Administration, a Federal Farm Credit Board (hereinafter referred to as the "Board"). Said board shall consist of thirteen members. Twelve of the members, one from each of the farm credit districts of the United States, shall be known as appointed members and shall be appointed by the President with the advice and consent of the Senate. In making appointments to the Board the President shall have due regard to a fair representation of the public interest, the welfare of all farmers and the various types of cooperative agricultural credit interests; shall give special consideration to persons who are experienced in cooperative agricultural credit; and shall, before making such appointments, receive and consider nominations made as follows: The Federal land bank associations in the district shall designate one nominee,

the production credit associations in the district shall designate one nominee, and the cooperatives which are stockholders or subscribers to the guaranty fund of the bank for cooperatives of the district shall designate one nominee in accordance with the procedure prescribed in sections 5 (e) and 5 (f) of the Farm Credit Act of 1937 for the nomination and election of members of a district farm credit board, except that only the two persons receiving the highest number of votes shall be included in the list of nominees prepared as a result of the voting under the procedure prescribed in said section 5 (e): *Provided,* That the names of all those who are tied for second place as a result of said voting shall be included in the list; and in case of a tie in the voting under the procedure prescribed in said section 5 (f) all persons so tied shall be considered designated as nominees: *And provided further,* That if the same person would otherwise be on the list of nominees of more than one of said groups as a result of the voting under said section 5 (e) he may choose the one list on which his name shall appear, and otherwise his name shall appear only on the list of the two highest nominees of the group which gave him the highest percentage of its votes. Subsequent appointments shall be made after receiving and considering nominations made in like manner.

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[12 U.S.C. 636c.]

Farm Credit Administration Regulations (6 C.F.R. (Rev. as of Jan. 1, 1966)):

SEC. 70.90 *General authority to determine rates of interest.*

Loans to cooperative associations made by any bank for cooperatives shall bear such rates of interest as the board of directors of the bank shall from time to time determine with the approval of the Farm Credit Administration, but in no case

shall the rate of interest exceed 6 per centum per annum on the unpaid principal of a loan (12 U.S.C. 1141f).

SEC. 70.142 *Capital stock ownership required with respect to loans conforming to the Farm Credit Act of 1955; district banks.*

Each borrower from a bank for cooperatives shall be required to own at the time the loan is made at least one share of class C stock. The purchase price of such stock may be retained out of the loan. In addition, each borrower as defined by the Farm Credit Administration for purposes of this sentence, shall be required to invest quarterly in class C stock an amount equal to not less than 10 nor more than 25 per centum, as prescribed by the board of directors of the bank with the approval of the Farm Credit Administration, of the amount of interest payable by it to the bank during the calendar quarter. Payments for such stock shall be made quarterly or when the regular interest payments of the borrower are payable, but the stock shall be issued to the borrower as of the end of each fiscal year in the amount of the payments for stock made by it during the year. (Section 42(a)(3), Farm Credit Act of 1933, as amended; 12 U.S.C. 1134d.)

SEC. 70.162 *Allocations of surplus and contingency reserves; district banks.*

Net savings of a district bank for cooperatives which are placed in the surplus account or set aside as contingency reserves at the end of any fiscal year, as provided in section 36(a) of the Farm Credit Act of 1933, as amended (12 U.S.C. 1134l), shall be allocated to all farmers' cooperative associations which during any part of the fiscal year were primarily liable to the bank for the repayment of loans made by the bank pursuant to section 7 of the Agricultural Marketing Act, as amended (12 U.S.C. 1141e): *Provided*, That, if the bylaws of a bank so provide, no allocation shall be made to any associa-

tion which files with the bank prior to the beginning of a fiscal year a written refusal to accept such allocations for said year. Allocations shall be made in the proportion that the amount of interest accrued on the loans of each borrower bears to the total interest accrued on the loans of all borrowers during the fiscal year, and shall be recorded on the books of the bank as allocations for such fiscal year.

SEC. 70.165 *Same; cancellation and retirement of allocations of surplus of defaulting borrowers.*

In any case where the debt of the borrower is in default and the bank is authorized under § 70.153 to cancel and retire stock in the bank and apply the proceeds on the indebtedness, the bank may retire and cancel all or part of the allocations to the defaulting borrower in total or partial liquidation of the debt, as the case may be, but such allocations shall not be so retired and canceled until all stock of the bank owned by the borrower has been retired and canceled. All allocations of surplus to a defaulting borrower shall be retired and canceled before any allocations of contingency reserves to such borrower are retired and canceled.

SEC. 70.165a *Cancellation and retirement of stock and other equities of borrower in liquidation or dissolution.*

In the case of liquidation or dissolution of any present or former borrower from a bank for cooperatives, the bank may retire and cancel any capital stock or allocated surplus or contingency reserves or other equity interest in the bank owned by such borrower at the fair book value thereof, not exceeding par, as hereinafter indicated.

(*a*) The bank has reasonable assurance that the liquidation or dissolution is or soon will be completed and that the business of the borrower is not being continued in circumstances in which

it would be appropriate and feasible for the successor to acquire and hold the interests of its predecessor in the bank.

(*b*) The retirement of stock and other equities of any such borrower would not unduly affect the financial position of the bank.

(*c*) Any such retirement shall be subject to authorization as follows:

(1) Whenever the total amount of equities to be retired in any one case is $5,000 or less the Executive or Loan Committee of the bank may approve the retirement when authorized to do so by the Board of Directors;

(2) Whenever the total amount of equities to be retired in any one case is in excess of $5,000 but does not exceed $25,000, retirement may be made only upon prior approval of the Board of Directors; and

(3) Whenever the total amount of equities to be retired in any one case is in excess of $25,000, retirement may be made only upon prior approval of the Board of Directors, subject to approval of the Farm Credit Administration.

(*d*) At the same time, corresponding shares of stock which the regional bank was required to purchase in the Central Bank shall also be retired.

(*e*) A report of any retirements made hereunder showing the name of the association and the amount of separate equities retired for each shall be forwarded to the Director of Cooperative Bank Service at the end of each quarter.

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